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NOTES

WASHINGTON NOTES

THE ACCEPTANCE SITUATION

Some important developments in connection with the acceptance situation have occurred during the past few months. They are of such a character as may materially alter the general trend of banking opinion with respect to the future value of the acceptance as a basis for bank credit.

In the last annual report of the Federal Reserve Board, published at the beginning of the present year, it was noted that there had been an effort on the part of many concerns to obtain rulings from the Board which would enable the discounting of commercial paper which in the past had not been regarded as being of a type desirable for admission to Federal Reserve banks. In speaking of this matter the Board said:

Perhaps the most urgent appeal of this kind has been that the Board permit Federal Reserve banks to discount notes which have been placed on the market under an agreement between the borrowers and their bankers, providing for a considerable number of successive renewals, the advances having been made to the borrowers for a definite term of years. . . . The discount of paper based upon such an agreement for repeated renewals is not consistent with the underlying principles of the Federal Reserve act and the Board had no hesitation in stating that it did not regard paper subject to such agreements as a proper investment for Federal Reserve banks.

The acceptance situation, particularly in New York, has gradually developed to a point where it has been deemed necessary to outline the principles upon which the Federal Reserve Board was willing to proceed in its treatment of acceptance paper. In a recent letter, copies of which have been transmitted to all Federal Reserve banks, the Federal Reserve Board has accordingly laid the following basis of operations, viz.:

1. Acceptance credits opened for periods in excess of ninety days should in only exceptional cases extend over a period of more than one year, and in no case for a time exceeding two years.

2. Banks which are members of groups opening these credits should not buy their own acceptances; and where an agreement is made with the drawer, for purchase of acceptances for future delivery, the rate should not be a fixed one but should be based upon the rate ruling at the time of the sale.

3. Transactions covered by these credits should be of a legitimate commercial nature, and acceptances must be eligible according to the rules and regulations of the Board.

4. Whenever syndicates are formed, for the purpose of granting acceptance credits for more than moderate amounts, Federal Reserve banks should be consulted with regard to the transaction. The question of eligibility, both from the standpoint of the character of the bill and of the amount involved, will be passed upon by the Federal Reserve bank subject to the approval in each case of the Federal Reserve Board.

In the same letter it is noted that the application of these principles necessarily depends for its success upon the general spirit of co-operation of the banks subject to them, and it must be remembered that not only the quality, but also the quantity, of the acceptances accordingly placed upon the market will be of material importance in determining the Board's future policy. Acceptances of this kind must not be permitted to constitute the greater proportion of the acceptances outstanding at any given date, while the Board retains the power to declare acceptances ineligible, even though they may be based upon exactly similar transactions, whenever the total amount of acceptances already outstanding seems unduly large.

It is evident that the new conditions surrounding the creation of acceptance credits, even as modified by the Federal Reserve Board's circular, thus distinctly recognizes the so-called "syndicate renewal agreement" and thereby gives to the bankers' acceptance somewhat of the character of a firm or corporation note which has been guaranteed by a banker or a group of bankers. In the meanwhile there has been some development of trade acceptances which has tended toward the creation of paper representing the slower and longer-period commercial obligations of the country. Should these two parallel trends of development be allowed to proceed along their present lines, the question will necessarily arise whether the acceptance plan will not lose many of the principal merits that had been attributed to it by writers on banking.

WAR FINANCE CORPORATION

The War Finance Corporation bill, which passed the House of Representatives on March 21, was signed by the President on April 5, and thus becomes law. In a number of respects it has been subjected to important modifications since its first introduction in Congress. One which is of most importance to the Federal Reserve System is found in the provision relating to the conditions under which paper collateralized

by obligations of the War Finance Corporation may be admitted to discount at Federal Reserve banks. In effect, what has been done by the legislators has been to apply two methods of restriction or regulation, the one seeking to make plain the fact that short-term commercial paper is still to have the preferred position at Federal Reserve banks, the obligations of the War Finance Corporation being given a secondary status by the establishment of a differential rate of 1 per cent against them; the other being the limitation of War Finance discounts to those cases in which a bank presenting such paper is able to state that it is not possessed of commercial paper available for use as a basis for rediscount.

The obligations of the War Finance Corporation are necessarily of a nature intended for investment rather than for banking uses, and the opening of Federal Reserve banks to them must consequently be regarded merely as a provision designed to strengthen their technical position and to set at rest the attitude of the government with respect to them rather than a provision adopted in the expectation that any considerable volume of business in such paper would actually be undertaken by Federal Reserve banks. Assuming that they are thus in effect an emergency resource, it is not to be expected that they would come in large volume to Federal Reserve banks, and it is to be hoped that they would not find a permanent lodgment in any considerable quantities in the banks in general. Among the provisions now incorporated in the final draft of the War Finance Corporation measure is one which removes the power granted by the original bill to Federal Reserve banks to undertake open-market operations in the securities of the War Finance Corporation. Such advances as they make on the securities of this corporation must now, therefore, be dependent upon the application and indorsement of a member bank—a situation which merely limits the possibility of operations designed purely to aid the market.

The powers of the War Finance Corporation remain very large, and the connection between it and the Federal Reserve System is close enough to permit, theoretically at least, a very considerable draft to be made upon the Federal Reserve banks unless the new corporation is conducted with great care and conservatism. The debate on the measure has been notable for the expression of the general opinion that the adoption of the bill could be warranted only as a measure of emergency relief, and that were it not for the existing condition of war it would have no chance of consideration. A phase of the problem that has been distinctly contemplated in financial circles and to some extent in Congress is the possibility that the Finance Corporation may be made permanent,

and that government aid to corporate enterprises, perhaps upon some restricted basis, may be retained after the war is over. The present measure, however, provides for the termination of government activities within a reasonable time after the closing of the war, and thus leaves the possible future of such participation in very much the same position as the question of the continued operation of government railways. Neither question can be disposed of with the knowledge available at the present time, but, like every broad question, both must be left to be settled as the outcome of conditions whose trend of development no one can as yet foresee.

THE THIRD LIBERTY LOAN

The Secretary of the Treasury on March 26 made known the terms upon which the Third Liberty Loan will probably be floated. It was not possible to make a definite statement on the subject because of the fact that legislation is still necessary before the Treasury Department will possess the authority to carry into effect the plans for the loan which it has already devised.

In view of the previous announcement that it would borrow up to a maximum of three billion dollars from the banks on the strength of short-term certificates, the banks being requested accordingly to devote 1 per cent of their resources per week to the purchase of such certificates, it had been supposed that the new loan would be not less than six billion dollars, this expectation being based upon the comparison of the experiences in former loans. The amount now asked for is only one-half of that, it being authentically announced that as actual expenditures of the United States government and of the Allied governments have been much less than had been indicated by the estimates, the amount of the next loan will be only three billion dollars, the right being reserved to allot over-subscriptions. The Secretary will ask authority from Congress to issue bonds bearing interest at the rate of $4\frac{1}{4}$ per cent per annum, acceptable at par and accrued interest in payment of United States inheritance taxes, and having the benefit of a sinking fund of 5 per cent per annum during the period of the war and for one year thereafter. It is the belief of the Secretary that the rate now proposed is sufficient, and that, by restricting unnecessary capital issues, and by inducing the people who subscribe for Liberty Bonds to save and to keep them for investment, and by purchases with the sinking fund from those who find themselves compelled to sell, future increases in the interest rate may be avoided. In order to put an end to the expectation of higher interest

rates, it is proposed that the conversion privilege shall be eliminated from the new bonds, but the holders of Liberty Bonds of all existing issues will be given an opportunity to convert their bonds into the new $4\frac{1}{4}$ per cent bonds. In addition to the foregoing principal items of the proposed program, Congress will be asked for authority to issue bonds to the amount of \$4,500,000,000 in addition to those now authorized, in order to provide for future issues; for authority to issue additional Treasury certificates of indebtedness; for authority to make additional loans to the Allied governments during the summer; and for authority to deposit income and excess-profits taxes with national banks, state banks, and trust companies throughout the United States in the same manner as the proceeds of the Liberty Loans.

The unexpectedly small volume of the projected loan is necessarily indicative either of a forthcoming new loan shortly after its conclusion, or else renewed resort to banks after the issue of bonds now announced has been used to fund certificates of indebtedness already in the hands of the banks, which are taking them up under the plan of financing announced some weeks ago. There has naturally been disappointment in financial circles in the fact that the new loan has been offered at the $4\frac{1}{4}$ per cent rate instead of the $4\frac{1}{2}$ per cent which had been expected in consequence of the establishment of that rate of interest for the short-term certificates of indebtedness. At the same time it is recognized that a material advance in the rate of interest on government obligations almost necessarily involves a corresponding increase in the rate of interest allowed by banks on deposits, and thus in the rate of interest charged for the discount of commercial paper. The effect of government financing upon general financial conditions has grown much more complex as time has advanced.

GOVERNMENT CONTROL OF RAILROADS

The bill known as Senate 3752 became law on March 21 by the signature of the President, as an act "to provide for the operation of transportation systems while under federal control, for the just compensation of their owners, and for other purposes." While this legislation has not been materially altered in the course of its progress through Congress, some changes of considerable interest have been introduced into it. As now passed, it requires that every railroad taken over by the government shall, during the period of federal control, "receive as just compensation an annual sum payable from time to time in reasonable instalments for each year, and pro rata for any fraction of a year, for the period of such

federal control, not exceeding the sum, equivalent as nearly as may be, to its average annual railway operating income for the three years ended June 30, 1917." In computing this basis for allowance to the carriers the average annual railway-operating income is to be ascertained by the Interstate Commerce Commission and certified by that body to the President. This means that the methods of ascertaining operating income laid down in the past will practically govern in the process of estimate. Federal taxes assessed under the war-revenue legislation are, however, to be paid by the carrier out of its own funds, or to be deducted from the compensation allowed.

While proper provision is to be made for maintenance, repair, and depreciation "in order that the property of each carrier may be returned to it in substantially as good repair and in substantially as complete equipment as it was at the beginning of federal control," the act contains elaborate provisions in the case of controlled or operated roads for determining the legal status of roads while under public management.

In conclusion it is prescribed that the federal control of railroads provided for in the law "shall continue for and during the period of the war and for a reasonable time thereafter, which shall not exceed one year and nine months next following the date of the proclamation by the President of the exchange of ratifications of the treaty of peace." The power is, however, given to the President to relinquish control of any line or system of transportation that he may choose in the meantime, subject, of course, to specified conditions. This practically places the railroads of the country upon a government-guaranteed basis, they being assured a rental equal to their average return during the three years in question. As one of these years is customarily reckoned "poor," one distinctly good, and the third about intermediate, it seems to be the judgment of well-informed men that the basis of compensation thus arrived at is, on the whole, reasonable, safe, and fair. The effect of the plan is already evident in the unexpected strength that has been shown by railroad securities of the country, particularly by railroad stocks, both since it became tolerably certain that the measure would be enacted, and especially since it was finally signed and sent to the statute book.